

Mercury Systems (MRCY)

\$80.32 (As of 02/04/20)

Price Target (6-12 Months): **\$84.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 10/16/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

2-Buy

Zacks Style Scores:

VGM:D

Value: D

Growth: B

Momentum: F

Summary

Robust organic growth, including the expansion of the microelectronics business, aided Mercury's fiscal second-quarter 2020 results. Strong demand for products resulted in significant deal wins, which drove the top line. A raised view for fiscal 2020 is encouraging. Moreover, modernization in radar, electronic warfare and C4I is high, providing the company with new opportunities in weapon systems, space, avionics processing, and mission computing and embedded rugged service. Domain expertise in analog and digital integration has helped it build a solid long-term relationship with defense prime contractors. However, though Mercury has been steadily winning development contracts from the federal government, these low-margin deals are likely to affect its profitability in the long run. Also, intense competition from CACI and SAIC is a concern.

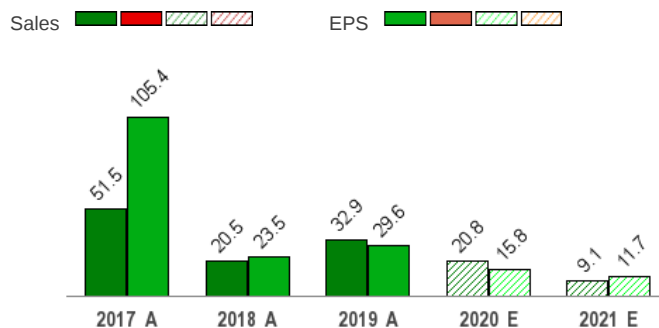
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$89.44 - \$57.71
20 Day Average Volume (sh)	377,091
Market Cap	\$4.5 B
YTD Price Change	16.2%
Beta	1.06
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Computer - Peripheral Equipment
Zacks Industry Rank	Top 23% (59 out of 255)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	12.5%
Last Sales Surprise	0.5%
EPS F1 Est- 4 week change	1.6%
Expected Report Date	05/05/2020
Earnings ESP	0.0%
P/E TTM	41.2
P/E F1	37.7
PEG F1	3.2
P/S TTM	6.2

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	193 E	213 E	222 E	243 E	863 E
2020	177 A	194 A	200 E	220 E	791 E
2019	144 A	159 A	175 A	177 A	655 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.54 E	\$0.59 E	\$0.62 E	\$0.70 E	\$2.38 E
2020	\$0.44 A	\$0.54 A	\$0.52 E	\$0.63 E	\$2.13 E
2019	\$0.39 A	\$0.47 A	\$0.50 A	\$0.47 A	\$1.84 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 02/04/2020. The reports text is as of 02/05/2020.

Overview

Founded in 1981 and headquartered in Andover, MA, Mercury Systems, Inc. is a provider of sensor and safety critical mission processing subsystems. The company was earlier known as Mercury Computer Systems and changed its name to Mercury Systems in November 2012.

The company's products and solutions are supplied to about 300 defence and intelligence programs with 25 U.S. defense prime contractors.

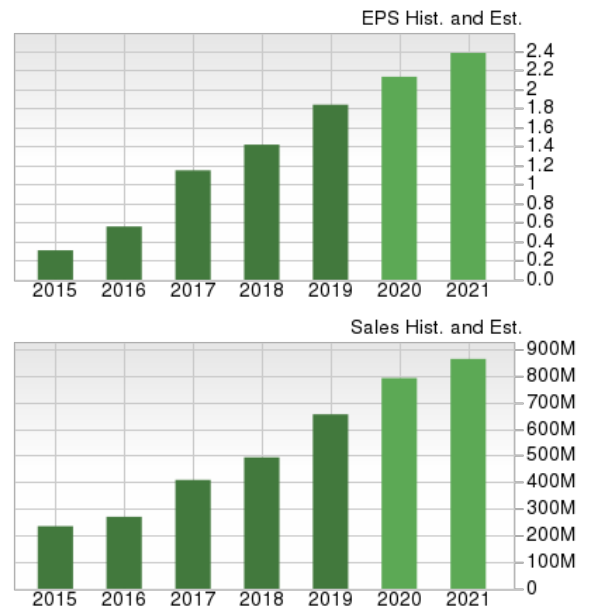
This apart, the company produces hardware products, including components, such as power amplifiers and limiters, switches, oscillators, filters, equalizers, converters, chips, integrated circuits, and memory and storage devices.

Other products offered by Mercury Systems include embedded processing modules and boards, switch fabric boards, input/output boards, digital receiver boards and transceivers, etc. Graphics and video processing, Ethernet and integrated subsystems are also part of the company's portfolio.

Additionally, Mercury Systems is involved in the designing, marketing and licensing of software and middleware technology under the name MultiCore Plus to expedite the development of signal and image processing applications on various heterogeneous and multi-computing platforms.

In fiscal 2019, Mercury Systems generated \$654 million in revenues, hitting the highest mark to date.

Mercury Systems faces significant competition from Harris Corporation, CACI International and Science Applications as the provider of technology services to the U.S. government.



Reasons To Buy:

- ▲ Mercury is expected to benefit from high demand for electronic warfare, ISR and other related market segments in the coming years, as it continues to hone its expertise in design and development of electronic subsystems for these markets. Per the Renaissance Strategic Advisors, the global aerospace and defense electronics market, which was estimated to be \$103 billion in 2018, is poised to reach \$117 billion by 2022. Moreover, the U.S. defense electronics market is expected to grow from \$51 billion in 2018 to \$57 billion in 2022. Further, the company works with a number of key defense prime contractors on a regular basis, which should ensure healthy flow of orders.
- ▲ The long-term DoD budget pressure due to the two-year Budget Control Act, additional expenditures creeping into Overseas Contingency Operations account, flat budget growth and like, is making more and more contractors opt for upgrades of the electronic subsystems on existing platforms. This is expected to increase the demand for the company's cost-effective and open-architecture products.
- ▲ The company's continued efforts and investments, which have resulted in successful completion of deals, have created about \$800 million worth of potential C4I opportunity based on the estimated lifetime value of its top 30 programs. Management noted that the C4I market, which encompasses avionics, command and control, electronic warfare (EW), and dedicated communications, is growing faster than the overall defense space, which is encouraging it to increase its stronghold in it. Per Zion Market Research, the C4ISR market (Communication, Command & Control, Computers, Intelligence, Surveillance & Reconnaissance, and EW) is expected to witness a CAGR of 3.6% between 2018 and 2024 to hit \$127.2 billion globally. Moreover, per Transparency Market Research, the C4ISR market is expected to reach \$132.3 billion by 2026, at a CAGR of 3.8% over 2018-2026. These projections make us optimistic about Mercury's growth prospects.
- ▲ The company's significant investments in embedded computing technology reflect in its recently released board-to-board data transmission rates of 100 Gbps. Through this, Mercury aims to enable faster next-generation PCIe Gen-4 Ethernet and InfiniBand high-speed switch fabrics. These fabric switches run within OpenVPX embedded computing subsystems. Per Mordor Intelligence, the global embedded computing systems market is expected to witness a CAGR of 6.6% over the period of 2018 to 2023. This is promising for companies like Mercury with long-standing stronghold in the industry.
- ▲ Moreover, Mercury's domain expertise in analog and digital integration has helped it build a solid business relationship with defense prime contractors for a long time. Its embedded computing servers including the suite of EnsembleSeries blades have delivered processing solutions with long lifecycles, high performance, environmental resiliency, interoperability and SWaP optimization for 35 years.
- ▲ Mercury has a history of expanding through acquisitions. These buyouts have added significant value to the company and expanded its total addressable market. Management noted at the end of fiscal 2018 that it invested a total of \$620 million on acquiring seven firms, and it plans to continue growing inorganically through acquisitions. In the third quarter of fiscal 2019, Mercury reported acquired revenues (20% of total revenues) of nearly \$34.8 million, attributable to the acquisitions of Themis Computer, Germane Systems and GECO Avionics. We believe that continued acquisitions will aid the company's growth.

High demand for electronic warfare, increased upgrades on electronic subsystems, and continued flow of deals are aiding Mercury's growth.

Reasons To Sell:

- ▼ Unfavorable contract mix is also likely to hurt the company's profitability. The company continues to witness increase in service-led contracts compared with legacy product based deals, which is expected to be a drag on margins.
- ▼ Though Mercury has been steadily winning development contracts from the federal government, these low-margin deals threaten to affect the company's profitability in the long term.
- ▼ Customer concentration is a major risk for Mercury. Its revenues were concentrated in two defense prime contractors, including Lockheed Martin and Raytheon for the last three consecutive years. These defense prime contractors comprised an aggregate of 37% of revenues in fiscal 2019, which is significant. This exposes the company to major revenue loss even if one of the customers ends its association with Mercury.
- ▼ Moreover, in fiscal 2019, about 95% of Mercury's revenues came from sales to the U.S. federal government either as a prime contractor or subcontractor. Due to this massive dependency, changes in the government's IT spending budget is a huge deciding factor for the company's top-line growth. Moreover, these contracts are subject to extensive legal and regulatory hurdles, which are stringent, and subject to change from time to time. The government also investigates operations periodically to ensure that the terms and conditions have been properly adhered to. Deviations from the terms laid out by the government might result in huge penalties or termination.
- ▼ Mercury competes primarily in the government IT services arena, which, like other government sectors, consists of many competitors of various sizes. Its main competitors include ManTech International Corporation, CACI, Unisys, Accenture, IBM — all of which are established players in the industry. Consequently, the company has to continuously invest in value drivers, which act as a hedge against competition. These increase its operating costs and reduce profitability.

Unfavorable contract mix and large number of low-margin contracts are hurting the company's profitability.

Last Earnings Report

Mercury Beats on Q2 Earnings & Revenues, Raises View

Mercury Systems reported second-quarter fiscal 2020 (ended Dec 27, 2019) results, wherein both top and bottom lines outpaced the Zacks Consensus Estimate.

Non-GAAP earnings per share of 54 cents grew 14.9% year over year and beat the Zacks Consensus Estimate by 12.5%.

Revenues came in at \$194 million, marking a year-over-year jump of 22%. The metric also surpassed the Zacks Consensus Estimate of \$193 million.

Robust organic growth, including the expansion of the microelectronics business, drove the company's performance.

Strong demand for products resulted in significant deal wins, which drove the top line.

Quarterly Details

Organic revenues (91.5% of total revenues) grew 12% to \$177.6 million in the quarter.

The company reported Acquired revenues (8.5%) of \$16.3 million, attributable to the buyouts of GECO Avionics, The Athena Group, Syntonic Microwave and American Panel Corporation.

Sensor and Effector Mission Systems revenues rose 24% year over year and accounted for 57% of total revenues.

Revenues from Command, Control, Communications, Computers and Intelligence (C4I) represented 30% of total revenues and grew 22% year over year.

Modernization in radar, Electronic Warfare and C4I was high, providing the company with new opportunities in weapon systems, space, avionics processing, and mission computing and embedded rugged service.

Mercury's total bookings increased 21% year over year to \$210 million, resulting in a 1.08 book-to-bill ratio. Key bookings included products like ALR-56, LTAMDS, ProVision and Paragon MODS.

The company ended the quarter with a backlog of \$728 million, up 39% year over year. Within the next 12 months, \$522 million worth products of this total backlog of orders are expected to be shipped.

The company's largest revenue programs were P-8, F-35, Filthy Badger, F-16 SABR and the next-generation missile system.

Margins

Gross margin for the fiscal first quarter expanded 100 basis points (bps) to 45.6%.

Adjusted EBITDA grew 16% year over year to \$42.8 million. However, adjusted EBITDA margin contracted 130 bps year over year to 22%.

Balance Sheet and Cash Flow

Mercury exited the quarter with cash and cash equivalents of \$182 million, up from \$161.3 million at the end of the previous quarter.

The company generated \$32.1 million of cash flow from operating activities compared with \$24.3 million in the prior quarter.

Free cash flow was \$20.7 million, up from \$14.7 million sequentially.

Guidance

For the third quarter of fiscal 2020, revenues are expected in the range of \$190-\$200 million.

Adjusted EBITDA for the quarter is anticipated in a band of \$42-\$44 million. Adjusted earnings are projected to be 50-53 cents per share.

Continued expansion in capex is expected in the fiscal third quarter owing to continued investments in business expansion, including a \$15-million investment to expand its trusted microelectronics business in Phoenix.

Mercury raised guidance for fiscal 2020. The company now expects revenues of \$780-\$795 million, increasing from the earlier guidance of \$775-\$790 million and implying 19-21% growth from the prior-year quarter's reported number. The company expects organic revenue growth between 13% and 14%, up from the previously expected 11%-12% for the current fiscal year.

Adjusted EBITDA for the fiscal is expected to be \$172.5-\$176 million, up from the earlier expectation of \$160.5-\$168.5 million.

Adjusted earnings for the fiscal are now estimated to be \$2.09-\$2.13 per share, increasing from \$2.03-\$2.11 guided earlier and suggesting an improvement of 14-16% from the year-earlier reported figure.

Quarter Ending **12/2019**

Report Date	Jan 28, 2020
Sales Surprise	0.50%
EPS Surprise	12.50%
Quarterly EPS	0.54
Annual EPS (TTM)	1.95

Recent News

On Jan 21, 2020, Mercury launched the EnsembleSeries CIOE-1390 module, a commercially-available compute module with Intel Atom multicore processors and embedded BuiltSAFE technology for flight safety certification.

On Jan 15, 2020, Mercury adopted cybersecurity company Tortuga Logic's products to support the development of hardware and software designs for DARPA's (Defense Advanced Research Projects Agency) Guaranteed Architecture for Physical Security (GAPS) program.

On Oct 24, 2019, Mercury announced DCM6112 digitization transceiver aimed to provide low-latency and wide bandwidth for critical electronic warfare applications.

On Oct 15, 2019, Mercury announced that it is investing \$15 million to expand its custom microelectronics business. The company will provide commercial silicon technology to the Department of Defense to accelerate future modernization efforts.

On Oct 2, 2019, Mercury announced that it will be added to the S&P MidCap 400 and S&P SmallCap 600 indices this month.

On Sep 23, 2019, Mercury completed the acquisition of APC for \$100 million to expand its position in the growing avionics market.

On Sep 16, 2019, Mercury introduced the EnterpriseSeries RES Aero rugged rackmount server product suite that provides enterprise-class data center-caliber processing to compute-intensive airborne applications.

Valuation

Mercury shares are up 3.1% in the past six months and 28.4% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Computer & Technology sector gained 12.9% and 19.2% in the past six months, respectively. Over the past year, the Zacks sub-industry and the sector gained 5.9% and 24.9%, respectively.

The S&P 500 Index has gained 13.4% in the past six months and 18.1% in the past year.

The stock is currently trading at 5.35X forward 12-month sales, which compares to 0.55X for the Zacks sub-industry, 3.63X for the Zacks sector and 3.45X for the S&P 500 index.

Over the past five years, the stock has traded as high as 6.38X and as low as 1.87X with a 5-year median of 3.72X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$84 price target reflects 5.6X forward 12-month sales.

The table below shows summary valuation data for MRCY

Valuation Multiples - MRCY					
		Stock	Sub-Industry	Sector	S&P 500
P/S F 12M	Current	5.35	0.55	3.63	3.45
	5-Year High	6.38	6.9	3.63	3.45
	5-Year Low	1.87	0.34	2.3	2.54
	5-Year Median	3.72	5.13	3.02	3
EV/S TTM	Current	5.81	0.86	4	3.08
	5-Year High	7.11	0.86	4.02	3.3
	5-Year Low	1.69	0.29	2.56	2.17
	5-Year Median	4.44	0.57	3.38	2.77
EV/EBITDA TTM	Current	26.45	6.84	11.58	11.4
	5-Year High	33.1	6.84	12.56	12.83
	5-Year Low	11.83	1.57	7.66	8.5
	5-Year Median	23.78	3.16	10.24	10.56

As of 02/04/2020

Industry Analysis Zacks Industry Rank: Top 23% (59 out of 255)



Top Peers

Heico Corporation (HEI)	Outperform
CACI International, Inc. (CACI)	Neutral
Curtiss-Wright Corporation (CW)	Neutral
FLIR Systems, Inc. (FLIR)	Neutral
Northrop Grumman Corporation (NOC)	Neutral
Raytheon Company (RTN)	Neutral
Science Applications International Corporation (SAIC)	Neutral
Teledyne Technologies Incorporated (TDY)	Neutral

Industry Comparison Industry: Computer - Peripheral Equipment				Industry Peers		
	MRCY Neutral	X Industry	S&P 500	CACI Neutral	NOC Neutral	SAIC Neutral
VGM Score	D	-	-	A	A	A
Market Cap	4.46 B	80.72 M	24.31 B	6.92 B	60.65 B	5.24 B
# of Analysts	6	1.5	13	7	7	6
Dividend Yield	0.00%	0.00%	1.78%	0.00%	1.46%	1.63%
Value Score	D	-	-	B	B	B
Cash/Price	0.04	0.26	0.04	0.01	0.04	0.03
EV/EBITDA	37.68	8.03	13.98	18.73	17.71	25.56
PEG Ratio	3.24	2.76	2.01	2.20	0.95	2.67
Price/Book (P/B)	3.39	1.86	3.29	2.76	6.88	3.77
Price/Cash Flow (P/CF)	37.08	8.31	13.58	19.41	13.12	20.10
P/E (F1)	37.71	35.14	18.82	22.03	15.60	14.69
Price/Sales (P/S)	6.17	1.51	2.66	1.28	1.79	0.87
Earnings Yield	2.65%	2.67%	5.30%	4.54%	6.41%	6.81%
Debt/Equity	0.04	0.06	0.71	0.75	1.60	1.35
Cash Flow (\$/share)	2.17	0.87	6.92	14.23	27.58	4.52
Growth Score	B	-	-	B	A	A
Hist. EPS Growth (3-5 yrs)	37.90%	14.62%	10.80%	17.55%	23.28%	15.97%
Proj. EPS Growth (F1/F0)	15.94%	31.51%	7.40%	19.83%	9.35%	13.99%
Curr. Cash Flow Growth	25.32%	-0.70%	10.22%	29.08%	2.21%	33.43%
Hist. Cash Flow Growth (3-5 yrs)	39.83%	12.96%	8.55%	11.71%	14.43%	16.56%
Current Ratio	5.05	2.06	1.21	1.33	1.13	1.20
Debt/Capital	4.03%	5.96%	42.91%	42.79%	61.48%	57.41%
Net Margin	8.55%	-0.23%	11.79%	4.92%	6.64%	2.62%
Return on Equity	7.19%	1.18%	17.24%	11.01%	39.51%	22.10%
Sales/Assets	0.51	1.00	0.55	1.02	0.84	1.30
Proj. Sales Growth (F1/F0)	20.77%	3.89%	4.10%	14.61%	5.46%	4.00%
Momentum Score	F	-	-	B	A	A
Daily Price Chg	2.64%	0.00%	1.49%	1.35%	-0.53%	1.48%
1 Week Price Chg	2.47%	-5.45%	-2.60%	-0.76%	-1.85%	-2.13%
4 Week Price Chg	10.92%	-3.76%	0.51%	7.42%	-3.51%	2.71%
12 Week Price Chg	11.82%	-5.53%	4.44%	20.25%	2.88%	10.76%
52 Week Price Chg	31.67%	-15.18%	14.65%	57.53%	29.93%	30.47%
20 Day Average Volume	377,091	27,673	1,935,862	181,062	916,267	436,189
(F1) EPS Est 1 week change	1.19%	0.00%	0.00%	2.62%	0.36%	0.00%
(F1) EPS Est 4 week change	1.57%	0.00%	0.00%	2.50%	0.28%	0.54%
(F1) EPS Est 12 week change	1.57%	-23.33%	-0.10%	2.78%	1.04%	-0.28%
(Q1) EPS Est Mthly Chg	-4.97%	0.00%	0.00%	0.48%	-1.60%	-0.45%

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	D
Growth Score	B
Momentum Score	F
VGM Score	D

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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